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No. 891

In the Supreme Court of the United States

OCTOBER TERM, 1960

ROSALIE M. SCHUBERT, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court (R. 2–20; Pet. App. 22–42)[1] is reported at 33 T.C. 1048. The opinion of the court of appeals (Pet. App. 1–20) is reported at 286 F. 2d 573.

JURISDICTION

The judgment of the court of appeals was entered on January 17, 1961 (Pet. App. 21). The petition for a writ of certiorari was filed on April 12, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "R." refers to the appendix to petitioner's brief in the court of appeals.

QUESTION PRESENTED

Whether an heir of property subject to a long-term lease, on which the lessee has constructed a building, is entitled during the lease term to depreciation or amortization deductions under § 167 of the Internal Revenue Code of 1954, notwithstanding that the value of the assets that will remain at the end of the lease term exceeds the value of the property as subject to the lease.

STATUTES INVOLVED

Sections 167(a), (f), and (g), 1011, and 1014(a) and (b) of the Internal Revenue Code of 1954 are printed in the Appendix, *infra*, pp. 14–16. The corresponding provisions of the 1939 Code (§§ 23(l) and (n), 113(a)(5) and (b), and 114(a)) are substantially the same.

STATEMENT

1. Petitioner's mother owned a lot and building, known as 409 East Broad Street, in the downtown business section of Richmond, Virginia. Adjoining No. 409, which had a frontage of 19.04 feet, were two other parcels, separately owned, having a combined frontage of 61.36 feet. In 1941, the G. C. Murphy Company ("Murphy") leased all three properties from their respective owners for terms ending on January 31, 1973. As permitted by the leases, Murphy removed the existing buildings and constructed on the three lots, at a total cost of $1,430,000, a five-story department store building. The building was completed on July 1, 1948, and had an estimated useful life of 50 years. Each owner had the right, at the end of the lease term, to require Murphy to add

the necessary walls and facilities to convert the part of the building on his lot into a separate rentable unit (R. 3–4, 29).

The annual rental under the lease for No. 409, for the period relevant here, was $13,750 to January 31, 1958, and $14,500 thereafter. Murphy was also required to pay all taxes and insurance in excess of $2,630 (R. 3–4, 34–35).

2. Petitioner's mother died on August 31, 1953, and the property passed, under her will, to petitioner.[2] Under § 1014(a) of the Internal Revenue Code of 1954 (*infra*, p. 15),[3] petitioner's basis in the property is defined as its fair market value at the date of her mother's death. That value—*i.e.*, of the lessor's interest in the property as subject to the lease—is agreed to have been $200,000, the value reported for estate tax purposes (R. 6). In her income tax returns for 1953, 1954 and 1955, petitioner allocated a part of that basis to the building and claimed depreciation deductions thereon under § 167(a) of the Code (*infra*, p. 14). The Commissioner disallowed the claimed deductions (R. 6). The Tax Court (R. 2–20) and the court of appeals (Pet. App. 1–20) upheld the denial of the depreciation deductions and also rejected petitioner's alternative claim that she should be

[2] Petitioner actually acquired only a life interest in a testamentary trust of the property (R. 5), but for all purposes relevant here she may be treated as the absolute owner of the property. See § 167(g) of the Internal Revenue Code of 1954, *infra*, pp. 14–15.

[3] Although the first tax year involved is governed by the 1939 Code, we will for convenience refer only to the 1954 Code. The corresponding provisions of the 1939 Code are substantially the same.

allowed a deduction for amortization of an allegedly "favorable" lease.

3. Morton Thalhimer, a qualified real estate appraiser, testified on behalf of petitioner. Together with the undisputed facts, his testimony, if accepted, would establish the following facts (as of the date of the decedent's death):

Value of lessor's interest (i.e., as subject to the lease)		$200,000
Intrinsic value of property (i.e., if free of the lease):		
Land	$154,000	
Building	149,305	
Total		[4] 303,305
Estimated useful life of building		[5] 44 yrs., 10 mos.
Term of lease		19 yrs., 5 mos.
Ratio of term of lease to life of building		43.31%

If, upon termination of the lease, No. 409 were to be separated from the adjoining properties and leased as a separate unit, its value would be less, Mr. Thalhimer testified, than if the three lots were re-let together without altering the building, since the narrow frontage of No. 409 (19.04 feet) would preclude efficient utilization of more than one and a half

[4] The real estate tax assessment of the property for 1953 was: land, $138,430; building, $134,210; total, $272,640 (R. 40). Mr. Thalhimer testified that the tax appraisals typically were somewhat less than actual value (R. 47); that he would value the land at $154,000 (R. 36); and that he would follow the tax assessor's ratio of the value of the land to the value of the building (R. 41). Using $154,000 as the value of the land and maintaining the same ratio between the land and the building, the value of the building would be $149,305. That valuation of the building, it may be noted, conforms to Mr. Thalhimer's testimony that the construction cost, five years earlier, of the portion of the building on petitioner's lot was between $150,000 and $180,000 (R. 30).

[5] Fifty years from July 1, 1948 (R. 4), and thus 44 years and 10 months from August 31, 1953.

floors if it were rented alone (R. 31–34). He gave no opinion, however, of what its value would be as a separate unit, saying that it was "a very difficult matter to estimate" (R. 31); that it could "vary greatly * * * [from] a very low figure to a figure in some relationship" to its value if not separated (R. 31–32); and that it was "very speculative as to what the value" would be (R. 34).[6] No evidence was offered of the likelihood that any of the three owners would exercise the right to have his portion of the original building walled off as a separate unit.

Mr. Thalhimer also testified that the rentals under the lease were greater by $2,595 (increasing to $3,300 in 1958) than the fair rental value of the land alone, and that the commuted value of the right to receive payments of that amount over the term of the lease (discounted at 5% to the date of decedent's death) was $38,685 (R. 36–38). There was no evidence that the lease rentals were greater than the fair rental value of the *improved* property as it will revert to petitioner at the end of the lease—*i.e.*, the land with a building having more than half of its useful life remaining.[7]

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[6] Pressed to express the effect of a separation of the properties in terms of the useful "life" of the building, the witness testified that the "physical life" would be the same and that, while the "economic life" would be shorter, it would be "highly speculative * * * to say what the economic life of one unit would be" (R. 32).

[7] The statement in the court of appeals' opinion that the witness "gave as his opinion that, at the termination of the lease, the income producing value of the building would be less than the rental value created by the Murphy lease" (Pet. App. 16) is somewhat misleading. The witness testified, not

ARGUMENT

In 1953, petitioner acquired an interest in property, subject to a long-term lease and improved by the lessee, worth $200,000. In 1973, when the lease terminates, petitioner will come into possession of the property improved with a building only 43.31% of the useful life of which will have expired. By petitioner's own evidence, the intrinsic value of the land and building in 1953 were, respectively, $154,000 and $149,305. Assuming constant market values—changes of value caused by factors other than the lapse of time being irrelevant to the allowance of depreciation—the land, being inexhaustible, will still have a value of $154,000 in 1973. The building, although exhaustible over time, will have 56.69% of its useful life remaining, and, applying straight-line depreciation principles, its depreciated value will be $84,644 (*i.e.*, the 1953 value of $149,305 depreciated by 43.31%). On those assumptions—*i.e.*, without speculating as to changes in market conditions or other contingencies[8]—the total value of the property that will revert to petitioner upon termination of the lease will be $238,644 (land, $154,000, plus depreciated building, $84,644), an *increase* of $38,644 over the

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that the rental value after the termination of the lease would be less than the lease rentals, but only that the rental value of the separate units, if the building should be divided up, would be less than the rental value of the three parcels if they were leased together, either to Murphy or to a new common tenant. See R. 31–34.

[8] Petitioner's apparent attempt to prove a lesser value for the building in 1973, contingent upon its being converted into a separate unit, was unproductive, the witness refusing to make such a "highly speculative" estimate (R. 31–34).

value of petitioner's interest when acquired in 1953 ($200,000). That is, although the intrinsic value of the property will depreciate over the term of the lease, the value of petitioner's *interest* in it will in fact appreciate as it ripens from a reversionary into a possessory one. While some exhaustion will ultimately take place by the time the land alone remains—the intrinsic value of the land ($154,000) being less than the value of the interest acquired ($200,000)—that exhaustion will not begin to occur until after the expiration of the lease.* During the lease term—the only period relevant here—petitioner's interest in the property is subject, in economic terms, not to exhaustion but to appreciation.

Notwithstanding the failure to show that any economic loss will accrue to her from the passage of time during the lease term, petitioner contends she is entitled to annual deductions during the term of the lease under § 167(a) of the Code, which allows "as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear * * * of property held for the production of income". Two theories are advanced—viewing the wasting asset as being, alternatively, the building or the lease—and as to each a conflict of decisions is alleged. On the first, as we shall show, there is no conflict, and on the second, whatever difference of view there may be as to the

*On the stated assumptions—*i.e.*, otherwise constant values and straight-line depreciation principles—the value of petitioner's interest, beginning at $200,000 in 1953, will steadily increase to $238,644 in 1973 (the end of the lease term) and then steadily decline to $154,000 in 1998 (the end of the building's estimated life).

theory, there is none that would affect the outcome on the facts of this case.

1. Petitioner first contends that, notwithstanding that the building was constructed by the lessee and is subject to its exclusive use during the term of the lease, she acquired an interest in the building that is subject to depreciation during the lease years. What depreciation petitioner may be entitled to take after the lease expires and her interest in the building becomes possessory is not in issue; the sole question is whether she has a depreciable interest in the building as such during the term of the lease.

The holding of the court below that an heir or purchaser of property on which a lessee has constructed a building does not acquire an interest in the building that is subject to depreciation during the term of the lease is admittedly (Pet. 9) in accord with the decisions of five other courts of appeals.[10] The sole conflict alleged is with the decision of the Second Circuit and of this Court in *Millinery Center Building Corp.* v. *Commissioner,* 350 U.S. 456, affirming 221 F. 2d 322. That case, however, involved a very different problem. There a lessee had depreciated over the original term of the lease the cost of a building it had constructed on the property. After exercising its option to renew the lease for an addi-

[10] *Goelet* v. *United States*, 266 F. 2d 881 (C.A. 2), affirming, *per curiam*, 161 F. Supp. 305 (S.D. N.Y.); *Commissioner* v. *Pearson*, 188 F. 2d 72 (C.A. 5), certiorari denied, 342 U.S. 861; *Friend* v. *Commissioner*, 119 F. 2d 959 (C.A. 7), certiorari denied, 314 U.S. 673; *First Nat. Bank of Kansas City* v. *Nee*, 190 F. 2d 61 (C.A. 8); *Commissioner* v. *Moore*, 207 F. 2d 265 (C.A. 9), certiorari denied, 347 U.S. 942.

tional term, it purchased the fee from the lessor at a price in excess of the value of the land alone. The Second Circuit rejected the lessee's claims that the excess could be deducted either in the year of payment or over the remaining term of the extinguished lease, but held that an allocable part of the payment could be treated as an additional cost of the building to be depreciated over the life of the building. This Court, limiting certiorari to the denial of the first two claims, affirmed. Plainly the taxpayer in that case, after purchasing the fee and thereby cutting off the reversion of the building to the lessor, had the full beneficial ownership and use of the building for the rest of its useful life, an interest that was admittedly subject to exhaustion as the building wore out. In this case, petitioner has no interest in the building as such except the right to it upon termination of the lease, and that interest, as we have seen, will increase rather than decrease in value as the lease expires.[11]

2. Alternatively, petitioner contends that she is entitled to treat the lease itself—to the extent that it provides allegedly "premium" rentals—as a wasting asset to which a part of her basis should be allocated and amortized over the term of the lease. The denial of such an amortization deduction is claimed to be in conflict with the decision of the Ninth Circuit in *Commissioner* v. *Moore*, 207 F. 2d 265, certiorari denied, 347 U.S. 942.

[11] That the results are not inconsistent is confirmed by the Second Circuit's own later decision denying depreciation during the lease term to an heir of property improved by the lessee. *Goelet* v. *United States*, note 10, *supra*.

In the *Moore* case, the taxpayer inherited property subject to a long term lease on which the lessee had constructed a building. The estimated useful life of the building was substantially shorter than the remaining term of the lease, so that only the land itself could be expected to remain at the end of the lease. Between the date that the lease was made (1924) and the date on which the taxpayer inherited the property (1938), property values in the area had declined drastically. As a result, the lease rentals, when the taxpayer acquired the property, were very much in excess of the fair rental value of the land, and the presence of the lease greatly enhanced the value of the taxpayer's interest in the property over the value of the land alone. Viewing the taxpayer-heir (with a fair-market-value basis) as being in the same position as a purchaser, the Ninth Circuit held, in substance, that the additional amount that a purchaser would pay for the property because of the lease (*i.e.*, in excess of what he would pay for the land alone) should be treated as the cost of the lease to be recovered over its term.[12]

[12] In discussing the problems of proof on remand, the court seems to have suggested that it would be necessary, to justify amortization, to establish not only the value added by the lease at the date of acquisition—and hence a basis for the lease—but also (in order to show exhaustion) that an equally favorable lease would not be available after termination of the existing lease. 207 F. 2d at 277. On remand, however, the Tax Court pointed out that, once the lease is viewed as a separate capital asset and an independent basis is assigned to it, that asset, being of limited duration, is necessarily a wasting one and it is immaterial what new lease might be available after it expires. 1955 P-H Tax Ct. Mem. Dec. ¶ 55,219.

The decision in the *Moore* case was in admitted (207 F. 2d at 275–276) conflict with that of the Seventh Circuit in *Friend* v. *Commissioner*, 119 F. 2d 959, and the opinion of the Fourth Circuit in this case seems in turn to express disagreement with the theory of the *Moore* case. Thus we agree with petitioner that, on the basic question presented by the *Moore* case, there is a conflict of decisions. We submit, however, that on its facts this case does not present that question and thus does not provide an appropriate vehicle for resolving that conflict. In distinguishing this case from *Moore*, we do not, of course, mean to imply agreement with that case. Our point is only that the theory of the *Moore* case is in any event inapplicable here and this case, therefore, affords no occasion to consider the merits of that theory.

The crucial difference between this case and the *Moore* case lies in the assets that will revert to the taxpayer upon termination of the lease. The underlying theory of the *Moore* case is that a purchaser or heir of property, subject to a lease should be allowed to recover out of income over the term of the lease the difference between the value of the interest acquired and the value of the assets that will remain at the end of the lease. In the *Moore* case, the useful life of the building being less than the term of the lease, the taxpayer would have, at the lease's end, only the land—an asset the intrinsic value of which was very much less than the value of the interest acquired. In this case, to the contrary, the taxpayer will receive both the land and a building with more than half of its useful life remaining—assets the in-

trinsic value of which (less depreciation to the end of the lease on the value of the building) *exceeds* the value of the interest acquired."[13] In short, the taxpayer here will have more at the end of the lease than she had at the beginning, while the taxpayer in *Moore* would have less. Thus, even if this Court should adopt the approach of the *Moore* case, petitioner would still not be entitled to depreciation or amortization during the lease term. Whatever the differences of theory expressed in the court of appeals' *opinion* in this case, its *decision* on the facts is fully consistent with the *Moore* case.[14] There is, therefore, no need in this case for the Court to undertake to resolve the existing conflicts.

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[13] Petitioner's computation of the value of the excess of the lease rentals over the rental value of the land (Pet. 7) is irrelevant even under the *Moore* case. It establishes at most only that the value of the interest acquired was greater than the value of the land; it in no way establishes that it was greater than the value of the assets that will remain at the end of the lease—the land *and* the building. That computation was deemed a proper measure of the exhaustion during the term of the lease in the *Moore* case only because the land was all that would be left upon its expiration. In this case, since the land is *not* all that will remain, it is irrelevant.

[14] See Rubin, *Depreciation of Property Purchased Subject to a Lease*, 65 Harv. L. Rev. 1134, which, while advocating the theory later adopted in the *Moore* case, would equally deny depreciation on the facts of this case.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

(f) *Basis for Depreciation.*—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

(g) *Life Tenants and Beneficiaries of Trusts and Estates.*—In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence

of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

* * * * *

SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter * * *), adjusted as provided in section 1016.

* * * * *

SEC. 1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

(a) *In General.*—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death, or, in the case of an election under either section 2032 or section 811(j) of the Internal Revenue Code of 1939 where the decedent died after October 21, 1942, its value at the applicable valuation date prescribed by those sections.

(b) *Property Acquired from the Decedent.*—For purposes of subsection (a), the following property shall be considered to have been ac-

quired from or to have passed from the decedent:

(1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;

* * * * *

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